



THE CITY OF SAN DIEGO
REPORT TO THE CITY COUNCIL

DATE ISSUED: February 21, 2007 REPORT NO: 07-039

ATTENTION: Council President and Members of the City Council,
City Council Meeting of February 26, 2007

SUBJECT: Water Revenue Increase and Capacity Fee Increase

REFERENCE:

REQUESTED ACTION:

1. Approve the water rate adjustments, increasing water system customer revenues incrementally by 6.5% in Fiscal Years 2008, 2009, 2010 and 2011, consistent with the Water Cost of Service Study (COSS), as referenced in the rate tables within the Proposition 218 notice.
2. Adopt the COSS recommendations including:
 - Monthly base service charge fee and commodity charge adjustments, as referenced in the rate tables within the Proposition 218 notice, effective July 1, 2007.
 - Increase in the number of user classifications, as referenced in the rate tables within the Proposition 218 notice, effective July 1, 2007.
3. Approve increase in water capacity fees from \$2,550 to \$3,047 per equivalent dwelling unit, consistent with the COSS, effective July 1, 2007.

STAFF RECOMMENDATION:

1. Approve the water rate adjustments, increasing water system customer revenues incrementally by 6.5% in Fiscal Years 2008, 2009, 2010 and 2011, consistent with the Water Cost of Service Study (COSS), as referenced in the rate tables within the Proposition 218 notice.
2. Adopt the COSS recommendations including:
 - a. Monthly base service charge fee and commodity charge adjustments, as referenced in the rate tables within the Proposition 218 notice, effective July 1, 2007.
 - b. Increase in the number of user classifications, as referenced in the rate tables within the Proposition 218 notice, effective July 1, 2007.
3. Approve increase in water capacity fees from \$2,550 to \$3,047 per equivalent dwelling unit, consistent with the COSS, effective July 1, 2007.

RAMIFICATIONS OF NO RATE INCREASES:

The proposed rate increases are on a critical timeline and are needed to meet the California Department of Health Services (CDHS) Compliance Order, and meet mandates under the Federal Safe Drinking Water Act. The Compliance Order requires the City to rehabilitate or replace deteriorating pipelines, and to replace aging pipes, pumps and other infrastructure to reduce the number of pipeline breaks and emergency repairs. Violation of the Compliance Order may subject the City to additional judicial action, including civil penalties specified in Health and Safety Code, Section 116725. Section 116725 penalties for violating a schedule of compliance for a primary drinking water standard can go as high as \$25,000 per day; for violating other standards, the penalties can go as high as \$5,000 per day.

The Water Department recently received a letter dated Feb 9, 2007, from the CDHS. (Attachment). This letter describes the results of a CDHS inspection of the City's water treatment plants and reservoirs. Within this letter, CDHS made comments on 52 items. These comments included warning of the possible loss of 60 million dollars in CDHS grant funding should the City not be able to fund the required 50% match. If the rates are passed, this match will be met.

CDHS also indicated the Otay Water Treatment Plant disinfection facilities and the Alvarado Water Treatment Plant old sedimentation basins 1 and 2 will both be added to an amended CDHS Compliance Order. The amended order will set dates in which the construction of these improvements must be started and completed. If the City is unable to meet these deadlines, CDHS could impose fines and sanctions as listed below. The Water Department is currently working on a response to the CDHS letter regarding operational issues, and will meet with CDHS as soon as possible. The Water Department believes it can address all concerns.

The Water Department is actively pursuing this rate increase to meet CDHS's requirements. The 4-year CIP forecast has identified funding for all of the CDHS compliance order items including those described on the recent letter dated Feb 9, 2007.

There are a number of enforcement tools that can be used by CDHS should the City fail to meet its obligations under the compliance order. They include the following:

1. Public Notification
2. Citations
3. Citation with fines
4. Public hearings
5. Mandatory water conservation
6. Service connection moratorium
7. Litigation
8. Add additional requirements to compliance order

In order to achieve our milestones and get back into the public bond market by August 30, 2007, the following timeline is imperative:

- January 8, 2007 - City Council hearing to set the public hearing as required by Proposition 218 - **Completed**
- January 11, 2007 - Proposition 218 notice must be mailed to meet the 45 day noticing requirement - **Completed**

- January 16, 2007 – City Council hearing to approve private placement interim financing of \$57 million and approve FY07 Capital Improvement Program **Completed**
- January 22, 2007 – Interim financing complete **Completed**
- February 26, 2007 - City Council public hearing to consider proposed rate increases (45 days after mailing the Proposition 218 notices) and capacity fee increase (mailed and published notices as required)
- Early April 2007 - Request for Proposals (RFP) issued for Bond Counsels and Bond Underwriters
- Late April 2007 – RFP's received and selections made. Finance document preparation begins.
- Late June 2007 – Introduction of ordinance authorizing the financing and legal documents
- July 1, 2007 – First 6.5% rate increase executed to support the bond issuance, capital program and operations and maintenance.
- Mid July 2007 – Council authorization of financing documents
- August 2007 – Referendum waiting period. \$57 million private placement financing proceeds exhausted.
- Late August 2007 – Bond closing and funds available to Water System.

This timeline is extremely aggressive and each milestone is critical to ensure the Water Department stays in compliance with DHS requirements. The timing of the public financing is designed so that as soon as the private placement funds are exhausted public funds will be in place to continue work on existing capital improvement projects. It should be noted that a public offering after June 30, 2007, as anticipated in this proposal, will require the completion of the audit for the City of San Diego Fiscal Year 2006 Comprehensive Annual Financial Report (CAFR). If the audit is not issued prior to August 2007, the Water Department may find it necessary to come back to council for a second interim private placement financing to meet the ongoing needs of the capital program.

Raftelis Financial Consultants, Inc. was retained to complete a Cost of Service Rate Study. The recommendations contained in their final report dated December 14, 2006, are consistent with and are reflected in the water rate case. The City Council's ability to deviate from these rates is limited: the rate adjustments proposed by this Report can only be changed if the alterations are consistent with the Cost of Service Rate Study. Changes that are inconsistent with the Study could violate the requirement of Proposition 218 that water fees not exceed the proportionate cost of providing the service to each parcel. Therefore, any proposed changes should be examined carefully.

SUMMARY:

Background

In response to state and federal mandates requiring the City to upgrade its water treatment facilities, replace cast iron water mains, and implement a wide variety of improvements throughout the water system, the Water Department has prepared a Capital Improvement Program (CIP) to address these issues as well as ensure sufficient capacity and water quality for the future. In order to support this CIP, additional funds will be required through a combination

of bonds, grants, state revolving fund loans and cash. This investment in infrastructure will require a series of rate increases beginning July 1, 2007.

Proposition 218

On November 5, 1996, the voters of the State of California approved Proposition 218, the "Right to Vote on Taxes Act." Proposition 218, effective July 1, 1997, added Articles XIII C and XIII D to the State Constitution, which contain a number of provisions affecting the ability of local governments to levy and collect both existing and future taxes, assessments, fees and charges. Article XIII D, section 6(a)(1) imposes noticing procedures for imposing a new or increasing an existing property-related fee or charge. This initiative changed the way the public is notified of proposed fee increases. Specifically, it requires that notices be mailed to all property owners of record at least 45 days in advance of the date on which a proposed property related fee increase may be adopted.

Pursuant to Proposition 218, the City provided property owners 45 days advance notice of the Council's formal consideration of these proposed rate increases. Notices were mailed to property owners of record and City of San Diego water bill customers, advising them the City Council of San Diego will hold a public hearing on February 26, 2007 to consider adoption of proposed revisions to existing water base fees and commodity charges. If adopted, the revisions under this proposal will become effective beginning July 1, 2007, and ending with the final increase effective July 1, 2010.

The Auditor & Comptroller's office independently reviewed the calculations for the sewer service rates and charges in the 218 notice and determined they are accurate.

Capacity Fee Noticing

Noticing of proposed increases to capacity fees is governed by the Mitigation Fee Act which is set forth in the California Government Code. Pursuant to Section 66016, the City is required to mail notice of the time and place of the meeting, including a general explanation of the matter to be considered, as well as a statement that data is available to the public indicating the amount of cost, or estimated cost, required to provide the service for which the fee or service charge is levied, and the revenue sources anticipated to provide the service. This notice is required to be mailed at least 14 days prior to the meeting to any interested party who files a written request with the City for mailed notice of the meeting on new or increased fees or service charges. Additionally, Section 66018 requires the City to publish notice of the time and place of the meeting, including a general explanation of the matter to be considered, in accordance with Government Code section 6062a. Under Section 6062a, the notice must be published at least two times in a 10-day period prior to the meeting, with at least 5 days intervening between the first and second notice.

The City complied with these requirements. The City mailed written notice on February 9, 2007, to those interested parties who filed a written request with the City for mailed notice as reflected on the list maintained by the Development Services Department. In addition, the City also mailed the notice to organizations existing on an internal list requesting notification. The mailed notice

contained all of the required information, and in addition included a general description of the purpose of the capacity fee charge as well as the amount of the proposed increase.

The City also published notice of the meeting in the San Diego Daily Transcript beginning February 12, 2007. Although the City is only required to publish the notice twice, the City arranged for the notice to be published ten times, with the last date of publication scheduled for February 23, 2007. The published notice contains all of the required information, and in addition, beginning February 15, 2007, the City arranged to expand the notice by also including a general description of the purpose of the capacity fee charge, the amount of the proposed increase, and a statement that the data is available for public review.

History

The City has managed and operated the water system since 1901 after purchasing the privately owned San Diego Water and Telephone Company. Since then the system has been expanded to supply approximately 270,000 accounts at the start of FY 2007, delivering approximately 78,204 million gallons of water per year.

The City's water system currently consists of nine raw water storage facilities, three water treatment plants, 30 treated water storage facilities and over 3,460 miles of water lines. One of the nine raw water storage facilities, Lake Hodges Reservoir, is not currently connected to a treatment plant but will be used as part of the Emergency Storage Project pursuant to an agreement between the City and San Diego County Water Authority (CWA). The City owns and operates three water treatment plants with a combined current capacity of 294 million gallons per day (MGD). The 30 treated water storage facilities ensure consistent delivery to the 90 different pressure zones with the aid of 49 water pump stations.

While the City has grown, local water sources have remained static. In general, between 6 percent and 10 percent of the City's water supply is derived from local water sources. The balance of the City's water supply is purchased from the CWA. These purchases from the CWA include treated water that is delivered to the City's water distribution system and raw water that is transported to the City's water treatment plants.

In 1994, the City of San Diego entered into a compliance agreement (attached) with the State of California Department of Health Services (DHS) with unanimous approval of City Council. This agreement required the City to correct operational deficiencies and begin badly needed capital improvements.

The City was notified in January of 1997 that it was not in compliance with this agreement. At that time, the DHS issued a Compliance Order. It also identified a list of projects the City must work in good faith to complete. That order also required the City to develop and submit a funding plan.

As a result, in 1997, the City Council approved the Water Strategic Plan, an associated eight-year capital improvements plan, the issuance of debt approved in 1998 for the capital program, and a series of three 6% increases to the water services charge revenues to support the first \$385 million of debt. These actions came after a year long planning effort by a citizen advisory group

that recognized and documented the need for an intensive effort to upgrade the City's water infrastructure in response to a Compliance Order issued earlier that year by the DHS, new federal drinking water requirements, the need to expand facilities to meet the needs of a growing community, and the need to replace or rehabilitate aging and deteriorating facilities throughout the system.

The 1997 Strategic Plan for Water Supply called for the doubling of water savings, from 4,236 million gallons per year (AFY) to 8,472 million gallons per year by 2005. This was to be accomplished by continuing successful water conservation programs. The City achieved its 2005 goal, and estimated a total of 30,350 AFY savings by the end of Fiscal Year 2006. 30,350 AFY is equal to 27.1 million gallons per day (MGD) of water saved. When compared to 11.6 mgd savings in 1997, the increase equates to 15.5 MGD. These efforts, along with proposed projects for cutting edge technologies such as brackish water desalination, are intended to provide the City with a reliable water supply that is less dependent on imports.

The three rate increases were applied to base fees only and took effect in August 1997, July 1998, and July 1999. The Department returned to the City Council in 2001 for additional rate increases in order to continue the capital program. As a precondition to approving further increases, Council requested the completion of a management review and a water cost of service study. The firm of Black & Veatch Corporation completed the Management Review Study in 2001 and it was presented to the Natural Resources and Culture Committee in January 2002.

On April 30, 2002, the City Council adopted Resolution 296437 approving the increase of water sales revenue by 6% per year each year beginning July 1, 2002, for a period of 5 years through July 1, 2006. This was to be accomplished by increasing the water base fee and commodity charges such that 50% of the increased revenue would be generated from each.

In October 2003, Black & Veatch Corporation completed a Water Cost of Service Study for the City. The study recommended adjusting the base charge to better reflect the actual fixed cost incurred by each class of user. It also recommended offsetting adjustments to the commodity fee to ensure full cost recovery.

This allowed the Water Department to issue another \$287 million in bonds in the fall of 2002 to continue the capital program. The funding from these bonds was fully expended in the spring of 2006. Since then, the Water Department has been using pay-as-you-go money to continue a scaled down capital program. As a result, the Water Department has had difficulties keeping up with the DHS Compliance Order and must ramp up to stay current with the order.

Current Needs

The City of San Diego water system is one of the most complex water systems in the nation, encompassing over 3,460 miles of pipelines, 49 pump stations and 30 treated water storage reservoirs. Such a sizeable system requires continuous upgrade and replacement of its aging components to meet current building standards, and updated Safe Drinking Water Standards.

The January 1997 Compliance Order was last amended in 2004, and included additional items that were not in the original Compliance Order. Furthermore, the Safe Drinking Water Act

amendments include new drinking water standards that all municipalities need to comply with by 2011 which directly affect the City's water treatment plants.

The City of San Diego is mid-way through a multi-year capital improvements program (CIP) to meet the regulatory requirements and upgrade its water infrastructure. The Water Department has completed 22 of the 31 projects in the DHS Compliance Order, and has made significant progress towards meeting the 2011 requirements of the Safe Drinking Water Act. Unfortunately, the City of San Diego was prevented from borrowing capital funds through the normal financial markets. The Water Department's inability to access the capital markets has significantly limited the Water Department's FY 2006 and FY 2007 CIP.

On February 9, 2007, the CDHS informed the Water Department of their intention to amend the Compliance Order to add some projects currently in our proposed rate case. This is to ensure they receive priority funding. They also indicated grants currently in place may be in jeopardy if significant funding is not forthcoming.

In fiscal years 2008 through 2011, the Water Department plans to expend approximately \$585 million for capital improvement projects. These funds will be used to continue many projects that have been delayed, such as upgrading and expanding the Alvarado, Miramar, and Otay Water Treatment Plants, the replacement of the Otay 2nd Transmission Pipeline, and the replacement of approximately 75 miles of cast iron water mains.

CIP projects to be funded from the proposed rate increases are listed in the attached schedule. There are a number of assumptions associated with capital project costs, including inflation and construction bid estimates which may change over time. Changes to the CIP will be brought before the City Council for their review and approval.

Continued on next page

Rate Case

In order to continue the Water Department's capital program and stay current with the CDHS Compliance Order, a 6.5% water sales fees and charges increase over the next 4 fiscal years is needed. This will allow the Water Department to cover debt service once it gets back into the bond market in 2007. The department issued a private placement of \$57 million and expects to get back into the public market with a larger offering during the summer of 2007.

The tables below identify projected revenue and expenditure estimates used for the Study.

SUMMARY OF WATER REVENUE

Line No.	Description	Estimated		Projected		
		2007	2008	2009	2010	2011
		\$	\$	\$	\$	\$
<u>Revenue from Rates</u>						
1	Revenue Under Existing Rates	278,601,800	280,955,700	282,626,200	284,666,200	287,281,900
2	Revenue from Rate Increases	-	18,262,100	37,935,500	59,196,200	82,296,500
3	Total Revenue from Rates	278,601,800	299,217,800	320,561,700	343,862,400	369,578,400
<u>Other Operating Revenues</u>						
4	Reclaimed Revenue	4,012,000	7,013,382	7,832,539	8,304,302	9,472,200
5	Fire Service and Auto. Sprinkler Svc.	1,493,333	1,498,111	1,503,815	1,498,420	1,500,115
6	Backflow Charges	482,333	470,111	470,148	474,198	471,486
7	Service Charge	1,375,000	1,401,125	1,427,746	1,454,874	1,482,516
8	Subtotal Other Operating Revenues	7,362,700	10,382,700	11,234,200	11,731,800	12,926,300
<u>Miscellaneous Revenues</u>						
9	Land and Building Rentals	4,252,000	4,332,788	4,415,111	4,498,998	4,584,479
10	New Water Services	2,402,000	2,447,638	2,494,143	2,541,532	2,589,821
11	Services Rendered to Others	10,762,382	10,966,867	11,175,238	11,387,567	11,603,931
12	Other Revenue	393,813	401,295	408,920	416,690	424,607
13	Lakes Recreation	1,340,611	31,300	31,895	32,501	33,118
14	Subtotal Miscellaneous Revenues	19,150,806	18,179,900	18,525,300	18,877,300	19,236,000
<u>Other Income</u>						
16	Damages Recovered	290,200	295,714	301,332	307,058	312,892
17	Sale of Land	3,213,413	115,000	115,000	115,000	115,000
18	Subtotal Other Income	3,503,613	410,714	416,332	422,058	427,892
19	Interest Income	8,744,400	21,201,700	13,548,700	22,393,200	15,716,000
<u>Capacity Charge Revenue</u>						
21	Capacity Charges	12,457,000	14,291,979	14,452,666	14,575,633	14,406,520
22	Total Revenues	329,820,319	363,684,792	378,738,898	411,862,391	432,291,111

SUMMARY OF OPERATING COSTS

Line No.	Description	Budget Year	Projected			
		2007	2008	2009	2010	2011
		\$	\$	\$	\$	\$
1	Water Purchase Costs	125,340,073	120,025,426	121,027,939	122,276,807	123,612,021
2	Administration	16,040,642	17,638,691	18,245,734	19,531,784	20,216,367
3	Customer Support	32,627,635	35,878,164	37,112,926	39,728,828	41,121,312
4	Water Operations	73,207,771	88,063,275	90,476,588	100,489,521	103,370,233
5	Engineering And CIP Management	8,863,795	9,746,851	10,082,293	10,792,943	11,171,232
6	Water Policy And Strategic Planning	6,952,380	7,645,011	7,908,118	8,465,521	8,762,235
7	Total O&M	263,032,296	278,997,419	284,853,598	301,285,404	308,253,399

SUMMARY OF PROJECTED CAPITAL IMPROVEMENT PROGRAM

Line No.	Description	2008	2009	2010	2011
1	Water Treatment Plants	71,312,495	47,600,699	29,499,980	3,389,671
2	Transmission Pipelines	9,782,916	17,109,888	4,620,633	38,476,636
3	Distribution Lines	31,200,000	43,280,000	45,102,614	46,933,049
4	Pump Stations	7,317,320	4,111,657	525,318	752,652
5	Treated Water Reservoirs	8,842,219	22,890,797	36,739,879	13,913,634
6	Reclaimed Water Facility	8,147,718	5,799,238	637,745	500,000
7	Miscellaneous	6,104,298	2,302,466	1,795,162	1,162,724
8	Contingencies	6,251,250	6,208,946	3,127,047	3,087,750
9	Raw Water Reservoirs	1,748,221	5,081,715	10,060,136	23,641,411
10	Program Management	4,000,000	4,000,000	4,000,000	4,000,000
11	Total	154,706,437	158,385,406	136,108,514	135,857,527

In addition, the following Water Rate Model Assumptions were made:

Population Growth Projections: City of San Diego growth projections are based on San Diego Association of Governments (SANDAG) 2030 Forecasts which was approved by the Board of SANDAG in November 2003. The growth projections for FY08 – FY10 are 1.1% annually and 1% annually thereafter. These rates are applied to the number of customer accounts. Current accounts are from the Water Utilities Customers Information System Monthly Rate Code Summary (Actual).

Right of Way Fees: No Right of Way fees are included.

Private Financing: Private short-term financing of \$57 million in January 2007. This amount will cover the balance of the FY07 CIP. Additional Private Financing Funds will be required in FY 2008.

Public Financing: The model assumes a public financing in July 2007 of approximately \$335 million which includes refinancing the \$57 million private financing, and in July 2009 of approximately \$260 million.

Capital Financing: The model assumes that capital costs will be 80% financed and 20% pay-as-you-go in FY08 and later.

Capacity Charges: The capacity charge is a full cost recovery charge reviewed as part of the Cost of Service Study (COSS). The result of that study increases the capacity charge to \$3,047 (from \$2,550) which is incorporated in the rate model.

Fund Balance Interest: Interest rates estimated for projected earnings on fund balance are based on recent 15 years interest earnings using the U.S. Treasury Current Value of Funds Rate which is 4.5% beginning in FY09. The interest rate for FY07 and FY 08 are 3% and 4%, respectively.

Offerings Interest Rates: Interest rates are estimated for the private short-term financing to be 4.2% and for the projected public financing to be 6%, based on the financial advisors' estimates.

Inflation: Annual inflation for operations and maintenance costs, except Salaries and Wages, is 4% based on the most recent 15 year San Diego area consumer price index for all urban consumers. The annual inflation for capital projects is stated as a conservative 4% based on the Engineering News Record Construction Cost Index most recent 10 year annual average and 15 year annual average.

Salaries and Wages: Salaries and Wages are increased by 4% in FY08 but are not increased thereafter until FY13, consistent with the City's 5-year financial plan.

Position Reductions: Assumes the reduction of 63.2 positions in FY08 to reflect Mayor's direction to streamline.

Lakes Recreation: Assumes the transfer of the Lakes Recreation program to the Park and Recreation Department in FY08 reflecting the reduction of 31 FTEs and the associated reduction in O&M costs and revenue.

Retiree Health: The Water Fund will contribute its proportional share to the Retiree Health fund. There is a three year ramp up to full funding of an Annual Required Contribution. The cost is estimated at \$2 million in FY08 and ramps up to \$6 million in FY10 and stays at that level in FY11. Cost estimates provided by the office of the Chief Financial Officer.

Pension Costs: Additional pension costs are reflected based on the Water Fund's proportionate share to fully fund the City's contribution to the pension fund. This is estimated at \$2.4 million per year for FY08 thru FY11. Cost estimates provided by the office of the Chief Financial Officer.

Enterprise Reporting Program: Assumes the Water Fund's proportionate share of costs for implementation of an Enterprise Reporting Program consistent with the Mayor's response to the Kroll Report. Cost estimates provided by the office of the Chief Financial Officer.

General Government Services: Additional costs for General Government Services are reflected based on the reorganization of the City government and the allocation of additional departments not previously included in the calculation. Cost estimates provided by the office of the Chief Financial Officer.

Treated Water Purchases: Rate case assumes the City will not be a net purchaser of treated water beginning in FY2010. Treated Water Purchases were approximately 33,000 Acre Feet/Year since FY03.

Water Conservation: Based on the City's Long-Range Water Resources Plan. Conservation is compared to water sales in FY89. Conservation is anticipated to increase from 11.38% in FY08 to 13.50% in FY18. An additional 2% is added each year for passive conservation.

Financial Results: The FY 2003, 2004, 2005 and 2006 financial results are based on the best available financial data from the office of the City Auditor and Comptroller.

Grants: The City is actively pursuing Proposition 50 grants and other grants, however they are not included in the model unless grant agreements have been approved by the City and the granting agency.

Capital Improvement Costs: Capital project costs are estimated based on current design, construction management, and construction cost plus a contingency equal to approximately 5% of construction cost. An inflation factor, calculated as described above under "Inflation", is added to the costs in the out-years.

Operating Reserve: This reserve is currently a 45 day operating reserve that will be ramped up over the next 4 years to 70 days in FY11.

Secondary Purchase Reserve: This reserve is intended as an emergency reserve for the purchase of water in the event of a drought or other emergency that suddenly disrupts the normal supply of water. The size of this reserve is intended to be equal to 6% of the annual water purchase budget.

Rate Stabilization Fund: The rate stabilization fund was established to stabilize the water rates in future years.

Unallocated Reserve: The unallocated reserve is intended to provide for unanticipated needs that arise during each year. Historically this has been used for unanticipated capital needs and large liability claims. This reserve will be set at 4% of the department's operating budget in FY08 and thereafter.

CIP Reserve: The CIP reserve is budgeted at \$5 million in the CIP budget. This reserve is intended to provide for emergency capital needs in the event of the catastrophic failure of a major capital facility.

Cost of Service Study

The Cost of Service Study (attached) is a comprehensive water cost of service and rate design study that includes a review of revenue requirements, user classifications, cost of providing service, and recommendations regarding the design of a system of user charge alternatives for the City's water service. The City Council approved an agreement with Raftelis Financial Consultants, Inc. (RFC) for a Cost of Service Rate Study (COSS) on October 24, 2006. The COSS recommends changes to user classifications, cost allocation and capacity charges which will serve to increase equity in the apportionment of system costs beginning in Fiscal Year 2008.

The focus of the COSS was on the City's retail water service and capacity charges. The specific objective of the Study is to develop cost of service rates that charge customers in proportion to the cost of serving them and to ensure capacity charges are sufficient for the expansion of the system. The cost of service findings and suggested changes are listed below.

Cost of Service is a methodical process by which revenue requirements are used to generate a system of fair and equitable costs in proportion to the service received for each user class. The cost of service allocation conducted in this study are based on the base-extra capacity method endorsed by the American Water Works Association (AWWA), a nationally recognized industry group. Under the base-extra capacity method, revenue requirements are allocated to the different user classes proportionate to their use of the water system.

The COSS recommendations in the final report dated December 14, 2006, are consistent with and are reflected in the water rate case. The City Council's ability to deviate from these rates is very narrow: the rate adjustments proposed by this Report can only be changed if the alterations are consistent with the Cost of Service Study. Changes that are inconsistent with the Study could violate the requirement of Proposition 218 that water fees not exceed the proportionate cost of providing the service to each parcel. Therefore, any proposed changes should be reviewed.

User/Usage Characteristics

The Water Department has various types of customers, which include Single Family Residential (SFR), Other Domestic (Multi-Family Residential), Commercial, Industrial, Temporary Construction and Irrigation. SFR comprise the bulk of customers with approximately 80% of all meters. Multi-Family account for more than 10% of the meters. Commercial, Industrial, Temporary Construction and Irrigation make up the remaining 10% of accounts, but account for approximately 40% of the usage.

Projected Annual Water Usage by Class for FY 2008 is:

Usage by Class	HCF	% of Total
SFR Blocks		
0 – 7	15,620,416	17.1%
8 - 14	8,943,800	9.8%
Over 14	9,915,197	10.8%
Total SFR	34,479,413	37.7%
Other Domestics (MFR)	20,519,164	22.4%
Total SFR and MFR	54,998,577	60.1%
Commercial	22,207,400	24.3%
Industrial	1,613,743	1.8%
Temp. Construction	346,667	0.4%
Irrigation	12,294,791	13.4%
Total Comm, Ind, Const, Irrig	36,462,601	39.9%
Total	91,461,178	100.0%

Revenue

The Water Department's principal source of revenues is from water sales. The total FY2008 revenue requirements from retail users – which is generated by totaling operation and maintenance, debt service, and cash-financed capital projects and deducting any revenue from other non-rate sources, is estimated to be \$287.4 million. Of this, approximately \$219.8 million are operating costs. The remaining \$68 million are capital-related costs associated with debt service and cash-financed capital projects. The primary sources of funding for capital improvements include water capacity fees, bond proceeds, grants, loans, pay-as-you-go revenues and interest earnings.

These revenue requirements are used to develop the fixed meter charges and commodity rates in a manner consistent with the cost of service principles. In order to meet projected revenue requirements and to maintain desired operating funds, the following annual revenue adjustments are recommended by the Study.

FY 2008	FY 2009	FY 2010	FY 2011
6.5%	6.5%	6.5%	6.5%

These new revenue demands have been offset through increased efficiencies in the operation and maintenance of both systems over the past few years. The improved efficiencies have effectively lowered the level of potential rate increases. Improved efficiencies helped the water system by keeping an additional 3% need off first year rate proposals. Higher rates would have also been necessary in subsequent years without continuing efficiency measures. At the Mayor's direction, an independent board will be appointed to oversee a new annual accounting review process to be put in place.

Rate Design

The City's water rates, effective as of July 1, 2006, include fixed service charges and water commodity rates. The fixed service charges are consistent across all user classes and vary by meter size. Service charges range from \$15.87 per month for a ¾ inch meter, which is typically used by Single Family Residential (SFR) customers, to \$6,514.14 per month for a 16 inch meter used by large industrial or wholesale customers. SFR Customers are billed on a three-tier rate structure. The remaining customers are charged a uniform rate of \$2.03 per hundred cubic feet (HCF) of water used.

Study Recommendations

The study recommends the City consider changes which include modifications of user classification, and cost allocations.

USER CLASSIFICATION

Based upon peaking characteristics of different customer classes the Study recommends that customers be classified as follows:

- SFR
- Other Domestic (Multi-Family)
- Commercial and Industrial
- Irrigation and Construction

The justification for creating new user classes is to track costs and design separate rates for these customers as a means of increasing equity among two classes of ratepayers.

Residential customers, including SFR and Other Domestic are estimated to have similar peaking characteristics. However, since only SFR rates are tiered, they are separated into SFR and Other Domestic classes. Commercial and Industrial customers are estimated to have similar peaking characteristics and can be included into another class because they have lower peaking characteristics than residential customers. Temporary Construction demand characteristics are similar to those of Irrigation; both customers have higher peak demands than the other classes, therefore it is reasonable to create a separate user class for them.

During peak demand relatively large amounts of water are used in short periods of time when compared to average usage. Peak usage is more costly to deliver than constant usage because it requires more pumping and large capacity facilities to produce and deliver the water in a short time span. To maintain fairness and equitability, rates should be higher for customers with higher peak usage.

SERVICE CHARGE

The Study recommends continued use of a rate structure that includes both a fixed monthly service charge, which is consistent for all users of similar sized meters, and a variable water usage charge. Costs to be recovered in the service charge include costs based on capacity such as:

- Maintenance of meters and services
- Portion of capital costs allocated to provide peaking capacity

- Public fire protection (hydrant maintenance)

And costs that are independent of meter size such as:

- Meter reading
- Customer billing and collection

The service charges for larger meters currently used by the City are higher than those derived from the application of industry standards. The Study therefore suggests that the City consider revising service charges to more proportionally recover its costs of providing service. The reduced revenue from service charges results in slightly higher commodity rates to maintain full cost recovery. Use of proposed COS based service charges would result in a reduced bill for some Single Family Residential customers, which would benefit low volume water users.

The main objective of the Study is to present options that will result in a proportionate allocation of costs to all user classes in proportion to the costs of serving these customers. The suggested revisions to service charges and commodity rates are designed to meet that objective. Under the proposed Cost of Service-based rates, any user greater than 13 hcf will receive higher bills, while users less than 4 hcf will experience a reduction in monthly bills. Higher volume SFR users will experience these increases due to the higher usage rates that accompany and offset reduced service charges. At the same time, COS rates will encourage conservation and provide low-volume users with material rate relief.

Capacity Charge

Capacity fees are collected to accommodate new growth and for users to buy into the system at an appropriate rate to compensate for the existing infrastructure. Capacity fees can only be used for capital costs and only those capital costs associated with expansion of the system. It is acceptable to use water sales revenues for both expansion and replacement. This requirement is a result of Assembly Bill 1600.

As part of the Study the costs associated with capacity fees were analyzed and RFC has recommended an increase from \$2,550 to \$3,047 per Equivalent Dwelling Unit (EDU). The Water Department is requesting Council approve this increase based on the recommendations of RFC at the February 26, 2007 council meeting.

This increase is mainly due to the capture of costs associated to recent additions to water system infrastructure. Significant additions took place during the re-audit of the City's 2003 financial statements. Capacity fees are used for new customers to buy into the existing infrastructure. The revaluation of the system, which was part of this audit, has resulted in an increase to this fee.

The Study recommendations are consistent with and are reflected in the water rate case. The City Council's ability to deviate from these rates is limited. The rate adjustments proposed by this Report can only be changed if the alterations are consistent with the Cost of Service Study. Changes that are inconsistent with the Study could violate the requirement of

Proposition 218 that water fees not exceed the proportionate cost of providing the service to each parcel. Therefore, any proposed changes should be carefully examined.

Wholesale Water Rate Pass Through

San Diego mostly relies upon imported water from Northern California and the Colorado River. The City currently purchases 90 percent of its water from the San Diego County Water Authority (CWA), which in turn purchases approximately 75% of its water from the Metropolitan Water District of Southern California (Metropolitan). CWA periodically increases the rates that it charges the City for water. These increases are based on costs of infrastructure, operations, maintenance, and water purchases from Metropolitan. These increases are known as "pass throughs".

On January 1, 2007, CWA increased the rates to the City of San Diego for Water Purchases. These increase will not be passed on to City of San Diego rate payers until July 1, 2007 when the first of the proposed 6.5% increases takes effect. This CWA increase was considered in the computation of the revenue requirements for this rate case. No additional future pass throughs are included in the revenue requirement under this rate case and cost of service study.

CWA is currently reassessing their needs and will be finalizing their reports for presentation to the CWA Board in May and June of 2007. It is anticipated that these reports will disclose the need for more rate increase pass throughs. These pass throughs are subject to Proposition 218 noticing.

The Water Department intends to come back to Council in the Fall of 2007 to request authorization to notice any future pass throughs, and to apply any appropriate rate increases identifiable at that time.

Mayor's Pre-conditions

As promised at the outset of his administration, Mayor Sanders directed City staff to undertake review efforts in response to concerns about potential mismanagement and inefficiencies in the water system. The Mayor's pre-conditions were set out as a requirement for considering any new rate recommendations included:

- Completion of a comprehensive examination of the budgets and rate structures.
- A review by outside auditors of past practices regarding the use of previous rate increases and bond proceeds.
- A detailed report regarding whether the water system had raised rates for projects that have not been, or never will be, completed.
- An analysis of the various operational and capital demands on the cash flow.
- A complete accounting of any funds that have been transferred out and for what purpose.
- A study of how San Diego's water rates compare with surrounding agencies, and
- A thorough report of what administrative expenses can be trimmed.

To that end, several reports were completed. These included reviews of the following:

- 1) tracing the use of revenues generated by a series of water rate increases for fiscal years 2003, 2004 and 2005 approved by the City Council;
- 2) tracing the use of the proceeds from the Series 2002 Water Revenue Bond

- 3) reviewing transfers and interfund charges (including Service Level Agreement charges) paid by the Water Fund to other City Funds (including the General Fund) for the fiscal year ending June 30, 2003

An Independent review was also completed for the Proposed Water Rate Case.

Results of Mayor's Preconditions

The City entered into agreements with the audit firm of Mayer Hoffman McCann P.C. (MHM) to perform a review of how bond proceeds and previous rate increases were used in the Water Department. MHM offered the findings of these reviews in a series of reports (see 4 reports attached) delivered to the Mayor in August 2006. The Mayor adopted all the remedial recommendations. These reports and their associated findings are listed below:

- Agreed upon services for rate increase
 - Finding: MHM was able to confirm the calculation of the revenue generated by each increase and to reasonably test the expenditures associated with these increases. The results illustrated that the revenues generated from the series of rate increases were appropriately expended and no specific recommendations were made.
- Agreed upon services for use of bond proceeds
 - Finding: MHM recommended that the bond fund only be charged for expenditures incurred and paid or payable. Generally Accepted Accounting Principles provide that expenditures would only be recorded if the City Attorney's office believed that it was probable that the City would have to pay the contractor. If the Attorney's office believed that the risk of loss was only possible or remote (as those terms are defined by professional standards), the liability and expenditure would not be recorded in accordance with Generally Accepted Accounting Principles.
 - Finding: MHM recommended that the CIP Analyst modify the allocation spreadsheets to include the allocation calculations for each project. The spreadsheets allocating costs across projects should also be retained with the vendor invoice to support project specific charges.
 - Finding: MHM recommended that the individuals initiating journal entries provide documentation explaining the rationale behind allocations between projects. The documentation should be attached to the journal voucher. Additionally, when a vendor invoice is allocated between projects, the individual preparing the allocation should attach documentation explaining the allocation methodology. The documentation for transactions posted to the general ledger should stand on its own without further explanation from staff.
- Agreed upon services for interfund transfers

MHM recommended the whole practice of the use of SLA's should be reviewed by the City. A committee was established to review the appropriateness of all SLA's and where appropriate more conventional cost allocation approaches will be implemented.

In March 2006, the City Council adopted a Cost Allocation Policy which describes when and how costs should be allocated to multiple funds and programs. This Policy will serve as the foundation for changes.

The City concurs with all of MHM's recommendations and will take immediate steps to ensure that this practice does not continue. Any funds inappropriately transferred in fiscal year 2006 will be returned to the appropriate fund, including but not limited to the findings and recommendations totaling \$644,206 found on pages 2 and 3 of the MHM Water Funds Transfer Report.

- Agreed upon services for proposed water rate increases
MHM applied and enumerated many procedures to ensure the water rate case was consistent and that estimates were in line with expectations and trends. Their review noted no significant differences that were not fully explained.

Efficiency Efforts

The Water Department has taken many steps in reducing administrative expenses and increasing efficiency:

- The Water Department has identified 63.2 Full Time Equivalents (FTE) that may be eliminated in FY 2007, for an estimated savings of \$5,118,035.
- Water Operations Division initiated a five year Bid-To-Goal contract in FY 2005. Audited savings to date from that program total \$9,747,723.
- Customer Support Division is currently in the process of obtaining final approval for the execution of their Bid-to-Goal contract for FY 2007.
- The Water Department is participating in Business Process Re-engineering initiatives and anticipates further savings to report at the end of the calendar year.

The department has been proactive in its efforts towards continuous improvement and efficiencies through the Water Operations Bid-to-Goal:

- Overtime costs reduced 25 percent from FY04. FY05 savings from reduced overtime was \$600,000. FY06 savings are anticipated to be an additional \$100,000.
- Motive equipment reductions and efficiencies in fleet usage in FY 2005 resulted in a savings of \$600,000. Fleet usage was re-evaluated, resulting in large number of pool vehicles returned to Equipment Division. Outside equipment rentals were also reduced.
- Based on the review of internal water purchase processes, the Optimization Program was established to centralize and improve systems operations to optimize our water supply and electrical usage. During FY05, due to the Optimization Program, treated water purchased was down 33 percent for a savings of \$1 million. FY05 energy savings from the Optimization Program was \$1.2 million. FY06 estimated energy savings are the same as FY05.
- The Construction and Demolition Material Recycling Program has resulted in a 60 percent reduction of material taken to the City's landfill.
- Customer Support Division savings due to process improvements and operational efficiencies is expected to total \$3.2 million for the period FY07 through FY11.

Mayor's Safeguards

The Mayor is committed to put in place safeguards to ensure that funds derived from rate payers are spent appropriately (see Attachment).

The Mayor's safeguard plan includes five specific elements:

- Creation of a new **Independent Rates Oversight Committee (IROC)**
- Installation of a **"Dedicated Reserve from Efficiencies and Savings" (DRES)** to help offset future rate increases in both systems
- Annual **financial audits** for both systems
- Annual **performance audits** for both systems beginning in 2008
- **Limiting future "Bid-to-goal" contracts** with City employees to one year

Current and Proposed Rates

The study and rate case have resulted in the following recommended water rate structure. Two components of water rates are the Service Charge and the Commodity Rates. The Service Charge is used to recover the fixed charges associated with the water system. The commodity rates recover variable components of the water system. A comparison of City of San Diego rates compared to other local water agencies is attached. The proposed service and commodity charges with rate increases are presented below:

		Service Charge				
Meter Size inches		2007	2008	2009	2010	2011
		<u>Existing</u> \$/month	<u>Proposed</u> \$/month	<u>Proposed</u> \$/month	<u>Proposed</u> \$/month	<u>Proposed</u> \$/month
5/8		15.87	15.18	16.17	17.22	18.34
3/4		15.87	15.18	16.17	17.22	18.34
1		17.11	22.17	23.61	25.15	26.78
1 1/2		75.41	38.13	40.61	43.25	46.06
2		116.24	58.09	61.87	65.89	70.17
3		414.73	104.98	111.80	119.07	126.81
4		692.00	171.83	183.00	194.89	207.56
6		1,542.72	337.46	359.39	382.76	407.63
8		2,081.78	537.01	571.92	609.09	648.68
10		2,793.63	770.49	820.57	873.91	930.71
12		3,892.44	1,435.00	1,528.28	1,627.61	1,733.41
16		6,514.14	2,499.62	2,662.10	2,835.13	3,019.42
		Commodity Rate				
Customer Class		2007	2008	2009	2010	2011
		<u>Existing</u> \$/HCF	<u>Proposed</u> \$/HCF	<u>Proposed</u> \$/HCF	<u>Proposed</u> \$/HCF	<u>Proposed</u> \$/HCF
SRF						
	0 - 7	1.731	2.262	2.409	2.566	2.732
	7 - 14	2.163	2.461	2.621	2.791	2.973
	Over 14	2.372	2.775	2.955	3.147	3.352
General Service						
	Other Domestic (MFR)	2.003	2.461	2.621	2.791	2.973
	Commercial & Industrial	2.003	2.357	2.510	2.673	2.847
	Temp Constr & Irrigation	2.003	2.524	2.688	2.863	3.049

The Proposed Rate Increase will result in the following increases to a customers monthly water bill based on the associated consumption amounts recorded as Hundred Cubic Feet (HCF). For customers with a ¾ inch meter Monthly Bill Calculation is as follows:

SFR - ¾" HCF/Month	FY 07 Existing \$/Mo.	FY 08 Proposed \$/Mo.	FY 09 Proposed \$/Mo.	FY 10 Proposed \$/Mo.	FY 11 Proposed \$/Mo.
2	19.33	19.70	20.98	22.35	23.80
4	22.79	24.23	25.80	27.48	29.27
6	26.26	28.75	30.62	32.61	34.73
8	30.15	33.48	35.65	37.97	40.44
10	34.48	38.40	40.89	43.55	46.38
12	38.80	43.32	46.13	49.13	52.33
13*	40.97	45.78	48.76	51.92	55.30
14	43.13	48.24	51.38	54.72	58.27
16	47.87	53.79	57.29	61.01	64.98
18	52.62	59.34	63.20	67.31	71.68
20	57.36	64.89	69.11	73.60	78.39

*Average Usage

13 HCF is the Average Usage for Single Family Residences (SFR) with a ¾ inch water meter. The median monthly household income in the City is \$5,173 (annual income of \$62,085) as of 2005. A \$45.78 water bill-the SFR bill assuming average usage and Proposed FY08 rates, represents less than one percent (1%) of monthly median household income. By EPA guidelines, bills of less than two percent (2%) of median housing income are deemed affordable.

Monthly Bill Calculations Other Domestic ¾ inch meter					
Other Domestic MFR - ¾" HCF/Month	FY 07 Existing \$/Mo.	FY 08 Proposed \$/Mo.	FY 09 Proposed \$/Mo.	FY 10 Proposed \$/Mo.	FY 11 Proposed \$/Mo.
20	55.93	64.39	68.58	73.03	77.78
40	95.99	113.6	120.99	128.85	137.23
60	136.05	162.81	173.4	184.67	196.67
80	176.11	212.03	225.81	240.48	256.12
100	216.17	261.24	278.22	296.3	315.56
120	256.23	310.45	330.63	352.12	375.01
140	296.29	359.66	383.04	407.94	434.45
160	336.35	408.87	435.45	463.75	493.9
180	376.41	458.08	487.86	519.57	553.34
200	416.47	507.29	540.27	575.39	612.79

For customers with a 1 inch meter Monthly Bill Calculation is as follows:

Commercial/ Industrial – 1"	FY 07 Existing	FY 08 Proposed	FY 09 Proposed	FY 10 Proposed	FY 11 Proposed
HCF/Month	\$/Mo.	\$/Mo.	\$/Mo.	\$/Mo.	\$/Mo.
50	175.56	155.98	166.12	176.91	188.41
100	275.71	273.82	291.62	310.58	330.77
150	375.86	391.67	417.13	444.24	473.12
200	476.01	509.52	542.64	577.91	615.47
250	576.16	627.37	668.14	711.57	757.83
300	676.31	745.21	793.65	845.24	900.18
350	776.46	863.06	919.16	978.9	1,042.53
400	876.61	980.91	1,044.67	1,112.57	1,184.89
450	976.76	1,098.75	1,170.17	1,246.24	1,327.24
500	1,076.91	1,216.60	1,295.68	1,379.90	1,469.59

For customers with a 2 inch meter Monthly Bill Calculation is as follows:

Temp. Const/ Irrigation - 2"	FY 07 Existing	FY 08 Proposed	FY 09 Proposed	FY 10 Proposed	FY 11 Proposed
HCF/Month	\$/Mo.	\$/Mo.	\$/Mo.	\$/Mo.	\$/Mo.
200	516.84	562.84	599.42	638.39	679.88
400	917.44	1,067.59	1,136.98	1,210.89	1,289.59
600	1,318.04	1,572.34	1,674.54	1,783.39	1,899.31
800	1,718.64	2,077.09	2,212.10	2,355.89	2,509.02
1,000	2,119.24	2,581.84	2,749.66	2,928.39	3,118.73
1,200	2,519.84	3,086.59	3,287.22	3,500.89	3,728.45
1,400	2,920.44	3,591.34	3,824.78	4,073.39	4,338.16
1,600	3,321.04	4,096.09	4,362.34	4,645.89	4,947.87
1,800	3,721.64	4,600.84	4,899.89	5,218.39	5,557.58
2,000	4,122.24	5,105.59	5,437.45	5,790.89	6,167.30

FISCAL CONSIDERATIONS:

PREVIOUS COUNCIL and/or COMMITTEE ACTION:

On January 8, 2007, the Water Department presented to Council the request to issue the proposition 218 notice. It was approved and the notice was subsequently issued.

The water rate subcommittee of the Public Utilities Advisory Committee (PUAC) on 11/29/2006 and the full PUAC on 12/4/2006 unanimously supported the proposed water rate adjustments of 6.5% in Fiscal Years 2008, 2009, 2010, and 2011, and the COSS recommendations.

COMMUNITY PARTICIPATION AND PUBLIC OUTREACH EFFORTS:

Public Input sessions have been held throughout San Diego as follow:

Various stakeholder meetings

All public outreach requested by the Community, Stakeholders or Council Members were scheduled

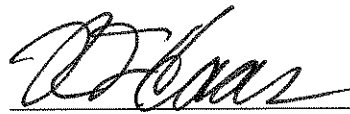
November 27, 2006 Town Hall Meeting San Ysidro Multi-Cultural Center
November 28, 2006 Town Hall Meeting Balboa Park War Memorial
November 29, 2006 PUAC Water and Wastewater Rate Sub-Committee Meeting
December 4, 2006 Full PUAC Meeting
December 5, 2006 Town Hall Meeting Rancho Bernardo Library
January 9, 2007 Eastern Area Planning Committee
January 10, 2007 College Area Community Council
January 12, 2007 Stakeholder Workshop on Cost of Service Study
January 19, 2007 Building Industry Association (BIA)
January 22, 2007 Navajo Community Planners
January 22, 2007 Community of Neighborhood Councils (CNC)
January 24, 2007 Natural Resources & Culture Committee (NR&C)
February 1, 2007 San Diego Regional Chamber Infrastructure Committee
February 1, 2007 Oakpark Community Council Meeting
February 5, 2007 City Heights Area Planning Committee
February 6, 2007 Taxpayers Association Board Meeting
February 20, 2007 Chamber Policy Committee
February 22, 2007 Chamber Board Meeting
Associated General Contractors (AGC)
February 14, 2007 Golden Hill Community Planning Group
February 14, 2007 Kensington-Talmadge Community Planning Group
February 15, 2007 El Cerrito Community Council Meeting
February 15, 2007 Fairmont Park Neighborhood Association
February 21, 2007 Tierrasanta Community Council

KEY STAKEHOLDERS AND PROJECTED IMPACTS:

Water customers will incur rate adjustments.



J.M. Barrett
Water Department Director



R.F. Haas
Deputy Chief of Public Works

Attachments:

1. Proposition 218 Notice
2. 4-year Capital Improvement Project Forecast
3. Raftelis Financial Consultants, Inc. Water Cost of Service Rate Study
4. Department of Health Service Compliance Order No. 04-14-96CO-022

5. Mayer Hoffman McCann P.C., Independent Accountant's Review (4 Reports)
6. Water Rate Comparison
7. Mayor's Safeguards Fact Sheet
8. February 9, 2007 Letter from California Department of Health Services
9. Mayor's memo on Independent Rates Oversight committee